[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 1066, S. 1550, S. 1557, and S. 1666)

SCHEDULED FOR A JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

AND THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on September 19, 1983, jointly before the Senate Finance Subcommittees on Savings, Pensions and Investment Policy and on Taxation and Debt Management.

The four bills scheduled for the hearing are (1) S. 1066 (the "Supplemental Retirement Benefit Act of 1983"); (2) S. 1550 (relating to the treatment of foreign income taxes on certain U.S. construction contract services); (3) S. 1557 (relating to exemptions from U.S. tax for interest paid to foreign persons); and (4) S. 1666 ("Capital Formation Tax Act of 1983").

The first part of the pamphlet is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, explanation of provisions, issues, and effective dates.

I. SUMMARY

1. S. 1066 — Senators Chafee, Bentsen, and Baucus

"Supplemental Retirement Benefit Act of 1983"

Present law

Under present law, a qualified defined benefit pension plan may provide cost-of-living increases to the retirement benefits of retired employees if the overall limits on contributions and benefits under qualified plans are satisfied. These cost-of-living increases are treated the same as other benefits under the plan and, therefore, are subject to minimum standards relating to participation, vesting, benefit accrual, and funding. The benefits (including cost-of-living increases) may be guaranteed by the Pension Benefit Guaranty Corporation (PBGC). Generally, benefits under a qualified plan are not includible in gross income until they are distributed by the plan. In addition, employer contributions to qualified plans are deductible within limits when contributed to the plan.

Present law also permits cost-of-living increases to be provided in a nonqualified supplemental plan. If a supplemental plan meets certain standards prescribed by the Department of Labor, the plan is classified as a welfare plan rather than a pension plan and, consequently, the plan is not subject to the minimum participation, vesting, benefit accrual, and funding standards applicable to pension plans. If the benefits are paid to the employee from the general assets of the employer, they will generally be taxable to the employee and deductible by the employer when they are paid. If the benefits are provided under a separate earmarked trust, however, the benefits generally are taxable to the employee and deductible by the employer when the employee's right to receive the amounts is no longer subject to a substantial risk of forfeiture.

S. 1066

The bill would permit an employer to provide (through employer contributions or a combination of employer and employee contributions) a "qualified supplemental benefit" under a qualified defined contribution plan to supplement the benefit under one or more defined benefit pension plans of the employer. The maximum supplemental benefit that could be provided by employer contributions would be the greater of (1) three percent of the primary retirement benefit or (2) a percentage of the primary retirement benefit equal to a seven-year average of the cost—of living—increase (generally determined using the Consumer Price Index). Additional supplemental benefits could be provided by employee contributions.

Amounts contributed by the employer to provide qualified supplemental benefits would not be subject to the overall limits on annual additions to defined contribution plans and would be de-

ductible when paid by the employer regardless of the usual limits on deductions. Qualified supplemental benefits would not be includible in income until the benefits are actually paid to the employee even though the employee has a nonforfeitable right to the benefit at an earlier date. Benefits provided under the qualified supplemental benefit arrangement would not be guaranteed by the PBGC.

The bill would generally be effective for taxable years beginning after 1982. The provision of the bill relating to the overall limits on contributions and benefits under qualified plans would be effective for years (within the meaning of Code sec. 415) beginning after 1982.

2. S. 1550 — Senators Chafee, McClure, and Grassley

Treatment of Foreign Income Taxes on Certain U.S. Construction Contract Services

Under current law, U.S. taxpayers must either deduct all foreign income taxes or credit all foreign income taxes. The bill would allow U.S. taxpayers (1) to elect to deduct foreign income taxes imposed on construction contract services (generally, architectural, engineering, and similar services) performed in the United States for use in a foreign country and (2) to credit all other foreign income taxes. Taxpayers would make this election on a country-by-country and year-by-year basis. The bill would be effective for taxable years ending after 1982.

3. S. 1557 — Senators Chafee and Bentsen

Exemptions from U.S. Tax for Interest Paid to Foreign Persons

Under present law, a U.S. withholding tax of 30 percent is generally imposed on annuities, interest, dividends, rents, royalties, and similar payments by U.S. persons to foreign investors if the payments are not effectively connected with a U.S. trade or business conducted by the foreign investor. Exemptions from the withholding tax are provided in certain situations. In addition, U.S. tax treaties generally reduce or eliminate the withholding tax on interest paid to treaty country residents.

The bill would repeal the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness. The withholding tax on interest paid to foreign investors would continue only in some (but not all) cases where the foreign investor is related to the U.S. obligor, where the foreign investor is controlled by U.S. persons, or where the foreign investor is a bank. Obligations yielding tax-exempt interest would also be exempt from U.S. estate tax.

The provisions of the bill would be effective for interest paid and after the date of enactment. The estate tax exemption would apply to deaths of decedents after the date of enactment.

4. S. 1666 — Senators Chafee, Bentsen, Durenberger, Boren, Wallop, and Pryor, and others

"Capital Formation Tax Act of 1983"

Under present law, gain or loss from disposition of a capital asset held for more than one year receives special tax treatment. Noncorporate taxpayers may deduct from gross income 60 percent of their net capital gains. As a result, net capital gains of noncorporate taxpayers are taxable under current law at a maximum 20-percent rate.

The bill would increase the deduction to 80 percent for net capital gains of noncorporate taxpayers attributable to dispositions of stock acquired through certain initial stock offerings and held by the taxpayer for at least five years. Thus, for noncorporate taxpayers subject to the 50-percent maximum regular rate, net capital gains attributable to dispositions of such stock would be taxable at a maximum 10-percent rate (assuming the alternative minimum tax did not apply). The bill would apply to sales or exchanges of such stock occurring after 1983.

II. DESCRIPTION OF THE BILLS

1. S. 1066 — Senators Chafee, Bentsen, and Baucus

"Supplemental Retirement Benefit Act of 1983"

Present Law

In general

Qualified defined benefit plans

Under present law, if an employer maintains a qualified defined benefit pension plan[1] for its employees, the plan is required to meet certain minimum standards relating to employee eligibility for plan participation, vesting, the rate at which benefits are accrued, and the rate at which the employer must contribute to the plan to fund the benefits. In addition, certain benefits provided under qualified defined benefit pension plans are guaranteed by the Pension Benefit Guaranty Corporation (PBGC).

Overall limits are provided with respect to the amount of retirement benefits that may be provided under a qualified defined benefit plan and the extent to which an employer may deduct contributions to provide these benefits.

Under present law, a qualified defined benefit pension plan may provide cost-of-living increases to the retirement benefits of retired employees if the overall limits on contributions and benefits under qualified plans are satisfied. These cost-of-living increases are treated the same as other benefits under the plan and, therefore, are subject to the minimum standards relating to participation, vesting, benefit accrual, and funding, and may be guaranteed by the PBGC. Generally, cost-of-living increases under a qualified plan are not includible in income until they are distributed.

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[1] Under ERISA, a pension plan is any plan, fund, or program that is established or maintained by an employer and provides retirement income to employees or results in a deferral of income to periods extending to the termination of covered employment or beyond (Sec. 3(2) of the Employee Retirement Income Security Act of 1974 (ERISA)). If a pension plan qualifies under the tax law (Code sec. 401(a)) then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution are accorded special long-term capital gain or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account (IRA) or to another qualified plan, and (4) limited estate and gift tax exclusions may be available. A qualified defined contribution plan is a tax-qualified plan under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants. A qualified defined benefit pension plan is a tax-qualified plan that specifies a participant's benefit independently of an account for contributions, etc. (e.g., an annual benefit of two percent of average pay for each year of employee service).

Qualified defined contribution plans

If an employer maintains a qualified defined contribution plan, the plan is required to meet the minimum standards relating to participation, vesting, and, in the case of certain defined contribution plans, funding. Benefits under defined contribution plans, however, are not guaranteed by the PBGC.

Overall limits are provided with respect to the amount of the annual addition (i.e., employer contributions, a portion of the employee contributions, and reallocated forfeitures) credited to an employee's account for a year under a qualified defined contribution plan. In addition, there are limits on the extent to which an employer may deduct contributions to these plans.

Under present law, if an employer makes a one-time contribution to a qualified defined contribution plan for the purchase of an annuity contract to provide cost-of-living adjustments to benefits under the employer's defined benefit plan, the contribution may not cause the annual additions for the year with respect to a participant to exceed the overall limits.

Qualified plan requirements

Minimum participation

Under present law, a qualified plan (defined benefit or defined contribution) generally may not require, as a condition of plan participation, that an employee complete more than one year of service or attain an age greater than 25 (Code sec. 410).

Vesting

The rules relating to qualified plans generally require that a plan meet one of three alternative minimum vesting schedules (Code sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions become nonforfeitable (vest) to varying degrees upon completion of specified periods of service with an employer.

Under one of these schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the tenth year). Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service. Under these two vesting schedules, all years of service with the employer maintaining the plan after attainment of age 22 generally must be taken into account for purposes of determining an employee's vested percentage. The third schedule takes both age and service into account, but in any event requires 50 percent vesting after 10 years of service and an additional 10 percent vesting for each year thereafter until 100 percent vesting is attained after 15 years of service. Under this schedule, all years of service with the employer must be taken into account for purposes of determining an employee's vested percentage if, during those years, the employee participated in the plan.

For years beginning after 1983, more rapid vesting is required under a top heavy plan.

Benefit accruals

Present law requires that a participant in a qualified plan accrue (earn) the benefit provided by the plan at certain minimum rates (Code sec. 411(b)). The accrual rules are designed to limit backloading of benefits. Under a backloaded accrual schedule, a larger portion of the benefit is earned in later years of service.[2] Accordingly, under a plan with backloaded accruals, an employee who separates from service before reaching retirement age earns a disproportionately lower share of the benefit payable at retirement age.

Funding

Present law requires that the benefits provided under a qualified defined benefit plan must be funded by the employer at certain minimum rates based on reasonable actuarial assumptions and the use of acceptable funding methods. These funding rules are designed to ensure that the plan will have sufficient assets to pay the participant's benefits when the participant retires. Certain defined contribution plans are also subject to minimum funding requirements.

Nondiscrimination

The benefits or contributions under a tax-qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated. In addition, the plan must meet standards designed to assure that the classification of employees covered by the plan is not discriminatory. The coverage rules provide that a qualified plan must include as participants enough employees to satisfy one of the following tests: (1) 70 percent of all employees, (2) 80 percent of all eligible employees if at least 70 percent of all employees are eligible, or (3) coverage of employees who qualify under a classification that does not discriminate in favor of employees who are officers, shareholders, or highly compensated (Code sec. 410(b)).

Limits on contributions and benefits

Under a qualified defined contribution plan, the overall limit on the annual addition with respect to each plan participant generally is the lesser of (1) 25 percent of compensation for the year or (2) $30,000.[3] Under a qualified defined benefit plan, the annual benefit derived from employer contributions generally is limited to the lesser of (1) 100 percent of high three-year average compensation or (2) $90,000.[4] If an employee participates in a qualified defined con-

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[2] For example, a plan's benefit formula might provide a benefit equal to two percent of average compensation multiplied by the number of years of plan participation. Under the minimum standards, a plan's accrual formula might provide that 2-1/7 percent of this benefit is earned for each of the first 20 years of service and that 2-6/7 percent of the benefit is earned for each of the next 20 years of service. An employee who separated after 20 years of service would have earned 42-6/7 percent (2-1/7 percent X 20) of a benefit equal to 40 percent (two percent X 20) of average compensation. The benefit would be 17-1/7 percent of the employee's average compensation (42-6/7 percent X 40 percent of average compensation). If the benefit accrual had been equal for each year of plan participation (2-1/2 percent of the benefit per year of participation), the benefit earned would have been 20 percent of average compensation (20 X 2.5 percent X 40 percent).

[3] Beginning in 1986, this amount will be adjusted for inflation.

[4] Beginning in 1986, this amount will be adjusted for inflation.

tribution plan and a qualified defined benefit plan maintained by the same employer, the fraction of the separate limit used by each plan is computed and the sum of the fractions is subject to an overall limit.

In addition, present law provides that no deduction by the employer is permitted for any year for employer contributions used to provide any benefits or annual additions in excess of the overall limits applicable to that year. Thus, in the case of a qualified defined benefit plan, no benefits in excess of the overall limits may be taken into account for purposes of computing the applicable deduction limit. Similarly, contributions taken into account in computing an employer's deduction for contributions to a qualified defined contribution plan must be reduced by the amount by which the annual addition for an employee exceeds the overall limit for the employee.

Guarantees

Under present law, a qualified defined benefit pension plan must pay annual premiums to the PBGC for each plan participant. The PBGC guarantees certain plan benefits in the event the plan terminates when there are insufficient assets to pay guaranteed benefits. Benefits under qualified defined contribution plans are not guaranteed by the PBGC.

Supplemental retirement benefits

A qualified defined benefit pension plan may provide for cost-of-living adjustments to the benefits of retired employees. These adjustments, however, may not cause the benefits under the plan to exceed the overall limits under qualified plans. Similarly, an employer may make a one-time contribution to a qualified defined contribution plan for the purchase of an annuity contract to provide cost-of-living adjustments to benefits under the employer's defined benefit plan if the contribution does not cause the annual addition with respect to any plan participant to exceed the overall limits under qualified plans.

These cost-of-living adjustments would be subject to the general rules relating to participation, vesting, benefit accrual, and funding that are applicable to qualified plans. Supplemental benefits provided under a qualified plan would be taxable under the general rules providing for tax treatment of distributions from or under qualified plans. Accordingly, these benefits generally would be includible in income when distributed by the plan. Supplemental benefits provided under a qualified defined benefit pension plan may be guaranteed by the PBGC.

Cost-of-living adjustments may also be provided in a nonqualified supplemental welfare plan if the plan meets certain standards prescribed by the Department of Labor. Under the Department of Labor standards, the plan must provide that (1) payment is made for the purpose of supplementing the pension benefits of a participant out of the general assets of the employer or a separate trust fund established and maintained solely for that purpose, (2) the maximum amount payable generally cannot exceed a percentage of the employee's retirement benefit equal to the increase in the Consumer Price Index, and (3) the payment may not be made before

the last day of the month with respect to which it is computed. If a supplemental plan meets these requirements, it is treated as a welfare plan rather than a pension plan. Welfare plans are not subject, under ERISA, to the minimum standards relating to participation, vesting, benefit accrual, and funding. In addition, these benefits are not guaranteed by the PBGC.

Benefits provided under a nonqualified supplemental plan that meets the Department of Labor standards are taxable when paid if they are paid out of the general assets of the employer. If the benefits are paid out of a separate earmarked trust fund, generally the value of the benefits would be includible in income when the employee's right to the benefits is not subject to a substantial risk of forfeiture (Code sec. 83). Under a nonqualified supplemental plan, no employer deduction is permitted for contributions to the plan until the benefits are includible in income of the employee.

Issues

The issues are (1) whether employers should be further encouraged to provide cost-of-living adjustments for pension benefits and (2) the level of security that should be provided to employees with respect to such adjustments.

Explanation of the Bill

The bill would provide that a defined contribution plan maintained by an employer does not fail to satisfy the requirements for tax qualification merely because the plan includes a "qualified supplemental benefit arrangement." The latter term would be defined to mean an arrangement that supplements the retirement benefit to which an employee is entitled under one or more defined benefit pension plans of the employer (the "primary retirement benefit") and that meets certain other requirements.

The bill would require that if a qualified defined contribution plan provides a qualified supplemental benefit arrangement, the arrangment must be available to any participant in a defined benefit pension plan of the employer who (1) is employed by the employer at the time the individual attains the earliest age at which the primary retirement benefit may be paid or becomes disabled and (2) is entitled to a primary retirement benefit at that time. In addition, the arrangement must permit an eligible participant to elect to purchase an individual or group annuity contract (including a guaranteed investment contract or similar arrangement) from an insurance company licensed to do business under the laws of any State. Under the bill, the election must be provided in the earlier of (1) the year in which the participant attains normal retirement age and retires or (2) the year in which payment of the primary retirement benefit begins. Payments under the annuity contract may not begin earlier than the year after the year in which the election is made.

Under the bill, the amount of the qualified supplemental benefit must be computed as a percentage of the participant's primary retirement benefit. The bill would permit the employer and participant to share the cost of the annuity in any proportion. In no event, however, could the portion of the supplemental benefit at-

tributable to employer contributions exceed the greater of (1) three percent of the primary retirement benefit or (2) a percentage of the primary retirement benefit equal to a seven-year average of the cost-of-living increase (determined using the appropriate Consumer Price Index or other comparable index selected by the Treasury Department).

The bill would provide that a qualified supplemental benefit arrangement would not be discriminatory if the classification of employees eligible to benefit under the arrangement satisfies the general rules relating to coverage of employees under a qualified plan (Code sec. 410(b)). Pre-retirement vesting in benefits under a qualified supplemental benefit arrangement would not be required and no accrual of the benefit would be required until the employee attains the earliest age at which retirement benefits may be paid or the employee becomes disabled. Accordingly, an employee who severs employment with the employer before retirement age would not be entitled to the qualified supplemental benefit. Qualified supplemental benefits would not be guaranteed by the PBGC.

If the supplemental arrangement is part of a profit-sharing plan, the bill would permit an employer to make contributions to the arrangement contingent upon profits for the year. If no employer contributions are made for a year, an employee who elected to participate in the arrangement for the year would be entitled to a refund of employee contributions. In addition, the employee would be entitled to participate, in any year in which the employer makes contributions, before any employee who made the election to participate at a later date.

Under the bill, contributions of the employer or the employee to a qualified supplemental benefit arrangement are not treated as annual additions for purposes of the overall limits on contributions and benefits. An employer would be allowed a deduction for contributions to a qualified supplemental benefit arrangement without regard to the usual limits on deductions for contributions to a qualified plan.

The tax treatment of benefits under a qualified supplemental benefit arrangement would be determined under the general rules relating to the tax treatment of benefits under qualified plans. Thus, in general, the benefits would not be includible in income until they are distributed.

Effective Date

In general, the bill would be effective for taxable years beginning after December 31, 1982. The provision of the bill relating to the overall limits on contributions and benefits under qualified plans would be effective for years (within the meaning of Code section 415) beginning after December 31, 1982.

2. S. 1550 — Senators Chafee, McClure, and Grassley

Treatment of Foreign Income Taxes on Certain U.S. Construction Contract Services

Present Law

U.S. treatment of foreign taxes—in general

U.S. persons[1] are taxable on their worldwide income, including their foreign income. U.S. taxpayers have a choice between two methods of treating foreign income taxes on their U.S. returns.[2] Taxpayers may (1) deduct foreign income taxes from taxable income, or (2) take full, dollar-for-dollar, credit for foreign income taxes.

The foreign tax credit is limited so that it may reduce U.S. tax on foreign income, but not U.S. tax on U.S. income. Taxpayers may not mix methods during any one year; i.e., a taxpayer who chooses to credit any foreign income taxes may not deduct any other foreign income taxes that year. [3]

Taxpayers generally must deduct, and cannot credit, foreign taxes (like excise taxes or property taxes) that are not income taxes.

Foreign tax credit

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country. Foreign tax credits may not offset U.S. tax on domestic income.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax any or all of the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to prevent double taxation.

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[1] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates (Code sec. 7701(a)(30)).

[2] Foreign income taxes include income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country (or possession of the United States).

[3] In most cases, taxpayers prefer a reduction of U.S. tax over a reduction of taxable income. Therefore, most taxpayers elect the foreign tax credit, and do not deduct foreign income taxes. Sometimes, however, a deduction is more helpful than a credit. A taxpayer whose return shows a net operating loss can increase that loss by deducting foreign taxes. The taxpayer may be able to deduct that net operating loss in a later year. That taxpayer could not benefit from a foreign tax credit, at least in the year of the loss (taxpayers may carry excess foreign tax credits back for two years and forward for five).

Some countries avoid double taxation by exempting foreign-source income from tax altogether. However, most countries, including the United States, avoid double taxation through a foreign tax credit system, providing a dollar-for-dollar credit against home country tax liability for income taxes paid to a foreign country.

A credit is also provided for a tax paid in lieu of a foreign income tax which is otherwise generally imposed (Code sec. 903).

Foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, a statutory formula limits the foreign tax credit to insure that the credit will offset only the U.S. tax on the taxpayer's foreign income. This limitation tends both (1) to prevent other countries from taxing the U.S. tax base, and (2) to discourage U.S. taxpayers from operating in countries that tax the U.S. tax base. Without the limitation, U.S. taxpayers who paid enough high foreign taxes might operate tax-free in the United States. U.S. taxpayers would tend to become indifferent to high foreign tax rates, because the U.S. Treasury would absorb the foreign tax burden.

The limitation operates by separating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") into two categories—U.S.-source taxable income and foreign-source taxable income.[4] Computing the limitation involves finding the ratio of foreign-source taxable income to total (pre-credit) taxable income. This fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income. This amount is the upper limit on the foreign tax credit.

The following example illustrates the computation of the foreign tax credit limitation. Assume that the U.S. taxpayer has foreign-source taxable income of $300 and U.S.-source taxable income of $200 for total taxable income of $500. Assume further that the pre-credit U.S. tax on the $500 is $230 (i.e., a 46-percent rate). Since 60 percent ($300/$500) of the taxpayer's total worldwide taxable income is from foreign sources, the foreign tax credit is limited to $138, or 60 percent of the $230 pre-credit U.S. tax. Thus, a taxpayer with foreign taxes paid in excess of $138 will only be allowed a foreign tax credit of $138 (the excess taxes paid may be carried to other years) and if the taxpayer has paid less than $138 in foreign taxes he will have a foreign tax credit equal to the amount of the taxes paid.

Taxpayers may credit any country's income tax so long as total foreign income—whether or not from that country—is high enough. Thus, one country's high tax may offset U.S. tax on income from a country that imposes no tax or a low tax. This is an "overall" limitation.

A taxpayer may credit taxes that foreign countries impose on U.S. income if total foreign income is high enough.

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[4] The pre-credit U.S. tax is the U.S. tax before all credits, that is, before the investment tax credit and other credits as well as the foreign tax credit.

Source of income — U.S. or foreign

For the foreign tax credit mechanism to function, every item of income must have a source, that is, it must arise either within the United States or without the United States. A source rule is important because the United States acknowledges that foreign countries have the first right to tax foreign-source income, but the United States insists on imposing its full tax on U.S.-source income.

The United States treats compensation for personal services performed in the United States as U.S.-source income (sec. 861(a)(3)). This income is U.S.-source income even though the person paying for the services resides in a foreign country and uses the services in a foreign country. For example, payments for a blueprint drawn in the United States for use in a foreign country are U.S.-source income. (If that foreign country taxes those payments, those taxes may be creditable income taxes, but a U.S. recipient with excess foreign tax credits cannot credit them. The taxpayer will be able to credit these foreign income taxes only if he or she has enough income from foreign sources that is subject to foreign tax at less than the U.S. rate.)

The United States Model Income Tax Treaty (which represents the U.S. negotiating position) and the Model Treaty of the Organization for Economic Cooperation and Development adopt the U.S. statutory rule that only the country where the services are performed may tax this income (Article 7 (Business Profits), Article 14 (Dependent Personal Services), and Article 15 (Independent Personal Services)). Most developed countries use this rule.

Some foreign countries, especially developing countries, have a tax source rule different from the U.S. rule, however. They treat income from personal services as having its source in the country where the services are used. Generally, in a developing country, the total value of services used is greater than the total value of services performed. A place-of-use source rule therefore gives a developing country a broader tax base than a place-of-performance source rule. Like the United States, these countries will insist on taxing income from sources within their borders. These countries also insist on using their own source rules. Therefore, these countries and the United States insist on taxing the same income. Double taxation arises.

The United States has few treaties with developing countries. However, under the income tax treaty between the United States and Morocco, payments from the Government of Morocco to a U.S. person for technical and economic studies have their source in Morocco (Articles 5(3) and 12(3)(c)). Payments from the private sector to U.S. persons for services for use in Morocco still have their source in the United States.

Problem of excess foreign tax credits

Under the U.S. rules described above, U.S. taxpayers may pay more foreign income taxes than they can credit on their U.S. tax returns. Such taxpayers have "excess foreign tax credits."

Excess foreign tax credits can arise for a variety of reasons. A principal reason is foreign tax rates that are higher than the U.S. rate. Another reason is that U.S. losses may reduce worldwide

income and thus creditable foreign taxes. Another reason is that foreign countries include in their tax bases more income than the United States would. "Base-broadening" by foreign countries can take various forms, such as the denial of deductions that U.S. law would allow. Another form of base-broadening arises when a foreign country taxes income that the United States considers U.S. income—when the two countries disagree about the source of income.

The inability to credit some taxes while deducting others

The reason that Congress requires taxpayers either to deduct all foreign taxes or to credit all foreign taxes is that allowing a deduction for the amount of taxes not credited would reduce the U.S. tax rate on U.S. source income. H. Rept. No. 708, 72d Cong., 1st Sess. 11-12 (1932). If both a credit and deduction were allowed, "preferential treatment would frequently be given to taxpayers receiving income from foreign sources." *Id.* at 12. For example, assume that a taxpayer has $100 income from a foreign country and $200 domestic source income, and has paid a tax of $80 to the foreign country. The limitation is 100/300 of $138 (46% tax on $300) or $46. There is then an excess foreign tax of $34. If this $34 is then deducted from the $300 total taxable income, the tax before credit is reduced to $122 (46% of $266). After crediting $46 of the foreign tax, the United States tax is $76. Since a 46% tax on the domestic source income of $200 is $92, the deduction has reduced the tax on domestic source income.[5]

Foreign taxation of payments for technical assistance

Many countries impose gross withholding taxes on payments for technical services (such as engineering services, architectural services, and other construction contract services) that a U.S. taxpayer performs in the United States for use within their borders.[6] Some countries waive or reduce these taxes in negotiations with foreign taxpayers on a case-by-case basis. Others reduce them through tax treaties. The United States treats these gross taxes as creditable income taxes (Treas. Reg. sec. 4-901-2(e), Example 31; Proposed Reg. sec. 1-903).[7] Therefore, a taxpayer who elects the foreign tax credit cannot deduct these taxes. Certain gross withholding taxes imposed on receipts of nonresidents with limited contacts in a country have become an internationally accepted form of taxation.

Impact of foreign taxes on construction service industry

Creditable taxes on income of a U.S. taxpayer who performs services in the United States for use in a foreign country present a problem if the taxpayer has excess foreign tax credits. That taxpayer will not be able to credit them because of the excess credits, and will generally not be able to deduct them because of the U.S. rule

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[5] This example comes from E. Owens, *The Foreign Tax Credit* 290 (1961), but reflects the reduction in the corporate tax rate since that time.

[6] Proponents of S. 1550 have listed several countries that impose such taxes: Algeria, Argentina, Brazil, Chile, People's Republic of China, Colombia, Ecuador, Indonesia, Korea, Malaysia, Mexico, New Zealand, Panama, South Africa, Spain, Tanzania, Thailand, and Venezuela.

[7] If a U.S. taxpayer performs services for a foreign government that taxes those services, however, the taxpayer may contend that it does not fully qualify as an income tax and that it should be, at least in part, a deduction that reduces U.S. taxable income.

that a taxpayer must either credit all foreign income taxes or deduct all foreign income taxes. These taxes may also create a problem of excess foreign tax credits for a taxpayer, because the income to which they relate is not foreign income under the U.S. rules. That is, that income does not increase the foreign tax credit limitation.

Examples

The following examples show the interaction, under current law, of (1) foreign taxes on U.S.-source income and (2) the foreign tax credit limitation. The first example shows the inability of a taxpayer with excess foreign tax credits to absorb foreign taxes on income that the United States considers to arise here. The second example shows that a taxpayer *without* excess foreign tax credits can absorb foreign taxes on income that the United States considers to arise here.

Example 1 — Excess foreign tax credits

Assume that a taxpayer who is subject to U.S. tax at a 46-percent rate earns $100 of net income for performing services in country A for use there. Country A imposes a 60 percent net income tax on the taxpayer. The taxpayer also earns $30 of net income for performing engineering services in the United States for use in country B. This $30 of net income consists of $100 of gross income reduced by $70 of expenses. Country B imposes a 20-percent withholding tax on the gross $100 payment. Thus, the taxpayer has $100 of net foreign income, and $30 of net U.S. income.

Under current law, if the taxpayer elects the foreign tax credit, the taxpayer would owe $13.80 of U.S. tax, computed as follows:

Table 1

Taxpayer With Excess Credits

	A	B	Total
(1) Foreign income	$100	$0	$100
(2) U.S. income	0	30	30
(3) Worldwide income			130
(4) U.S. tax before FTC			59.80
(5) Foreign tax	60	20	80
(6) FTC limitation			46
(7) Credit allowed (lesser of (5) or (6))			46
(8) U.S. tax ((4)−(7))			13.80

By taking the credit, the taxpayer would also have $34 of excess foreign tax credits available for carryback or carryover.

If the taxpayer, under current law, deducts foreign taxes, he or she would have taxable income of $50 ($130 of pre-foreign-tax income less $80 of foreign taxes). At a 46-percent U.S. rate, the taxpayer would owe U.S. tax of $23. Thus, in such circumstances, the taxpayer would elect the credit (and pay U.S. tax of $13.80) and forego the deduction for foreign taxes (which would cause U.S. tax of $23).

Example 2 — No excess foreign tax credits

Assume the facts are the same as in Example 1, except that Country A has a 25-percent tax rate (instead of a 60-percent rate). If the foreign tax credit is elected under current law, the taxpayer would owe U.S. tax of $14.80, computed as follows:

Table 2

Taxpayer Without Excess Credits

	A	B	Total
(1) Foreign income	$100	$0	$100
(2) U.S. income	0	30	30
(3) Worldwide income			130
(4) U.S. tax before FTC			59.80
(5) Foreign tax	25	20	45
(6) FTC limitation			46
(7) Credit allowed (lesser of (5) or (6))			45
(8) U.S. tax ((4)−(7))			14.80

If the foreign taxes are deducted under current law, the taxpayer would have taxable income of $85 ($130 of pre-foreign-tax income less $45 of foreign taxes). At a 46-percent U.S. rate, the taxpayer would owe U.S. tax of $39.10. In such circumstances the taxpayer would elect the credit (and pay U.S. tax of $14.80) and forego the deduction (which would cause U.S. tax of $39.10).

DISC 42.5

The Internal Revenue Code provides income tax deferral on up to ~~57.5~~ percent of the income of a Domestic International Sales Corporation (disc), a special purpose corporation that exports goods or services. Income from engineering or architectural services for construction projects located (or proposed for location) outside the United States is eligible for DISC treatment, whether or not the U.S. taxpayer performs the services in the United States.

Explanation of the Bill

In general

S. 1550 would allow taxpayers to elect (1) to deduct any foreign country's income taxes on construction contract services performed in the United States for use in the foreign country and (2) to credit other foreign income taxes. The income taxes that a taxpayer could elect to deduct include income taxes that are otherwise creditable under the Internal Revenue Code.

The bill would define construction contract services to mean engineering, architectural, design, project management, procurement, cost estimating, scheduling, construction planning, or construction mobilization services, or other services, including financial, administrative, clerical, data processing or reproduction services, which are related and subsidiary to any of those services.

A taxpayer would make the election to deduct taxes on construction contract services on a country-by-country basis, so that the

taxpayer could credit one country's taxes on construction contract services while deducting another country's similar taxes that year. A taxpayer could not, of course, credit any taxes that he or she elected to deduct under this provision.

A taxpayer would make these country-by-country elections on an annual basis. This election, like the election to credit foreign taxes, could be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of tax for the taxable year. The Internal Revenue Service has taken the position that, for the election to credit foreign taxes, that period generally expires three years after filing of the return for that taxable year (Reg. sec. 1.901-1(d)). The U.S. Court of Claims has held, however, that the period expires ten years after the filing deadline for the taxable year.[8]

The election to deduct a country's taxes on construction contract services would not be allowed if the Secretary of the Treasury finds that under the laws of a foreign country, citizens of the United States or U.S. corporations are being subjected to a higher effective rate of tax than are nationals, residents, or corporations of any other countries with respect to income from construction contract services. That is, taxes on income imposed by a country that discriminated against the United States would not be eligible for the election under the bill. However, a foreign country could grant favorable treatment to a third country in an income tax treaty without violating this non-discrimination rule.

Interaction with foreign tax credit limitation

General rule

In general, a taxpayer with excess foreign tax credits would make the election under the bill, while a taxpayer that did not have excess foreign tax credits would not make the election.

Example 1—Excess foreign tax credits

In Example 1 (set forth above under Present Law), Country A imposes a $60 tax on $100 of Country A income. The taxpayer also earns $30 of net income for performing engineering services in the United States for use in country B, on which Country B imposes a $20 tax. Thus, the taxpayer has $100 of net foreign income, and $30 of net U.S. income. By electing the credit, the taxpayer owed $13.80 of U.S. tax.

Under the bill, the taxpayer in example 1 would elect to deduct taxes from country B, while crediting country A's tax. The foreign tax credit would eliminate the taxpayer's U.S. tax liability on income from country A, and the taxpayer would have $14 of excess foreign tax credits available for use in other years.[9] The taxpayer would deduct the $20 country B tax from the $30 of net pre-foreign tax U.S. source income, leaving U.S.-source taxable income of $10. The taxpayer's U.S. tax would be $4.60. Thus, the taxpayer would

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[8] *Hart* v. *United States*, 585 F.2d 1025 (Ct. Cl. 1978)).

[9] If the taxpayer later generates low taxed foreign income, he or she could revoke the bill's election and use the greater excess foreign tax credit carryovers available for crediting all foreign taxes.

pay less U.S. tax by making the election ($4.60) than by crediting all foreign taxes up to the limit ($13.80 of U.S. tax).

Example 2—No excess foreign tax credits

In Example 2 (set forth above under Present Law), Country A imposes a $25 tax on $100 of Country A income. The taxpayer also earns $30 of net income for performing engineering services in the United States for use in country B, on which Country B imposes a $20 tax. Thus, the taxpayer has $100 of net foreign income, and $30 of net U.S. income. By electing the credit, the taxpayer owed $14.80 of U.S. tax.

If the taxpayer made the election that the bill would provide, he or she would owe $21 of U.S. tax on income from Country A (the pre-credit U.S. tax of $46 less the $25 foreign tax credit). The taxpayer would also owe $4.60 of U.S. tax on the $10 of net income for services used in Country B. This $25.60 total U.S. tax is greater than the $14.80 U.S. tax under current law, so the taxpayer would not make the election under the bill.

Issues

Foreign tax burden on U.S. construction service businesses

The principal issue the bill presents is whether the U.S. Treasury should absorb some of the foreign tax burden of some U.S. businesses that perform construction services in the United States for use overseas. The bill could improve the ability of some U.S. businesses to compete against foreign businesses.

Proponents of the bill indicate that the tax laws of some industrialized countries (like Holland, Germany, Canada, and the United Kingdom) permit deduction of taxes that lesser developed countries impose on income from construction contract services. These countries consider income from services to arise where the services are performed. Companies in these countries can use their foreign tax credit for foreign income taxes on foreign-source income, while deducting foreign income taxes on domestic-source income. Other countries (like Korea, and France and Switzerland by treaty) treat that income as foreign source, and allow a credit for the taxes under their credit mechanism. U.S. companies, by contrast, may be subject to double taxation, so they cannot easily compete directly with foreign companies, but can do so only by operating in foreign countries through foreign subsidiaries. To the extent that U.S. businesses forego producing services for use in foreign countries, the United States loses jobs. If these foreign taxes are seen only as a cost of doing business abroad, they should be deductible. On the other hand, the proposal could make U.S. tax law more favorable than the tax laws of the countries (United Kingdom, Holland) that allow deductions for foreign tax imposed on domestic source income. Few, if any, of those countries allow taxpayers the choice of crediting such taxes. In addition, in some cases, U.S. law is already more generous than that of other countries by allowing an overall foreign tax credit limitation rather than a per-country limitation.

The bill departs from traditional U.S. tax concepts that require taxpayers either to deduct or to credit all foreign taxes. Whenever

a taxpayer has U.S.—source income and credits some foreign taxes, deducting foreign taxes in excess of those creditable reduces the U.S. tax on U.S. income. This results in preferential treatment for taxpayers with foreign source income.

In some cases, the bill could allow foreign countries (1) the sole right to tax foreign income, and (2) the first right to tax U.S. income. As for foreign income, when a U.S. taxpayer has excess foreign tax credits, foreign countries already have the sole right to tax—the United States does not tax foreign income when foreign taxes are higher than U.S. taxes on that income. As for U.S. income, under the bill, a foreign country might appear to have the first right to tax. The United States would allow a deduction for foreign taxes on U.S. income, while the foreign country would not have to allow a deduction for U.S. tax on the same U.S. income. That is, the U.S. tax base is net income (after foreign tax), while the foreign tax base is generally gross income (before U.S. tax). Arguably, however, some foreign countries may impose gross withholding taxes at relatively low rates to take account of the disallowance of all deductions, so that the United States and the foreign country would have comparable rights to tax U.S. income.

Effect on foreign country taxation

A related issue is whether the approach taken in the bill would affect activity of foreign countries. On the one hand, enactment could encourage foreign countries where services are used to enact or to increase taxes on income from construction contract services. On the other hand, these countries may not be able to increase their tax rates without slowing the development they seek. Moreover, U.S. companies are not the only suppliers of construction services—tax increases in countries where services are used could force withdrawal of non-U.S. companies. Some countries would be reluctant to impose taxes so high as to drive away suppliers of services. Other countries may raise taxes to encourage local production of technical services. In any event, the bill would not apply to countries that use internal law to discriminate against U.S. enterprises.

Scope of bill's application

The scope of the bill's application presents a further issue. Construction services may produce the vast bulk of U.S. source income that other countries now tax. Computer services, attorneys' and accountants' services, and the like, may be of minor importance. The application to taxes on construction services income, moreover, may be proper because taxpayers can sometimes arrange to perform construction contract services in a particular location for tax reasons, while other kinds of income are not so easy to shift. Therefore, special rules to encourage performance of construction contract services in the United States may be proper. Moreover, construction contract services jobs may be more important to the United States than most other jobs, because use of U.S. construction contract services may frequently cause the user to buy U.S. exports. In addition, the United States may not be able to afford to let other countries surpass it in this field. The DISC rules that provide special treatment for income from architectural and engineering services (and for exports in general) for foreign use may be in-

adequate in this case. The DISC rules do not prevent double taxation, and those rules do not cover many of the services that the bill covers.

Other issues

Other issues involve whether other solutions to the problem of excess foreign tax credits are available. Arguably, Treasury or the taxpayers involved should pressure the foreign governments involved to conform their source rules to ours. It is unclear that such pressure would have any effect. Another approach would be to change the U.S. source rule so that at least part of certain types of services income have their source in the country where the services are used. This rule would allow the country where the services are used the first right to tax those services. A change in the source rules could have a greater revenue impact than that of the bill, and would be a departure from the approach of many developed countries. Another approach would be to require a company to elect the bill's treatment for all countries or for none during a given year, or to require companies to elect this treatment for periods longer than one year.

Revenue impact

The bill's revenue effect turns on whether U.S. businesses are now incurring taxes on income from construction contract services that they cannot credit. If so, the bill could bring work into the United States and thus increase revenues. If not, the proposal would create a revenue loss. The choice of a business situs involves a number of factors. Companies may now choose to perform work in the United States for business reasons, even though a U.S. location means a higher tax burden. Alternatively, tax planning may dominate the choice of where to perform construction contract services.

Effective Date

The bill would apply to taxable years ending after December 31, 1982.

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3. S. 1557 — Senators Chafee and Bentsen

Exemptions from U.S. Tax for Interest Paid to Foreign Persons

Present Law

In general

The United States taxes the income of U.S. citizens, residents, or corporations whether that income is from the United States or abroad (in the case of foreign source income, however, a dollar-for-dollar credit is allowed for any foreign income tax paid). Nonresident aliens and foreign corporations, however, are generally taxed on only their income which is from U.S. sources.

Withholding tax on foreign investors

In situations where the U.S.-source income received by a nonresident alien or foreign corporation is interest, dividends, or other similar types of investment income, the United States imposes a flat 30-percent tax on the gross amount paid (subject to reduction in rate or exemption by U.S. tax treaties, as described below) if such income or gain is not effectively connected with the conduct of a trade or business within the United States (Code secs. 871(a) and 881). This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442) and, accordingly, the tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and thus the foreign recipient files no U.S. tax return with respect to this income.

If the interest, dividend, or other similar income is effectively connected with a U.S. trade or business of the foreign investor, that income is not subject to the flat 30-percent withholding tax on gross income, but instead is included in the U.S. income tax return which must be filed for the business and is taxed at the ordinary graduated rates.

Exemptions from the withholding tax

The tax law provides a number of exemptions from this 30-percent tax on gross income. Interest from deposits with persons carrying on the banking business and similar institutions is exempt (secs. 861(a)(1)(A) and 861(c)). Original issue discount on obligations maturing in six months or less is exempt (secs. 871(a)(1)(A) and (C) and 881(a)(1) and (3)). Any interest and dividends paid by a domestic corporation which earns less that 20 percent of its gross income from sources within the United States (an "80/20 company") is also exempt from the 30-percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)). Also, interest on certain debt obligations which were part of an issue with respect to which an election had been made for purposes

of the expired Interest Equalization Tax is exempt (secs. 861(a)(1)(G) and 4912(c)).

The income of foreign governments from investments in the United States in bonds, stocks and other securities, or from interest on bank deposits, is generally exempt from U.S. tax (sec. 892). Treasury regulations deny the exemption for income which the foreign government receives from commercial activities in the United States or income which inures to the benefit of any private person. Although interest received by a foreign government might not qualify for the statutory exemption for foreign governments, that interest might be eligible for other exemptions (such as that available for interest on bank accounts).

There is no estate tax liability with respect to a debt obligation or a bank deposit yielding interest that would not be subject to the 30-percent withholding tax if the decedent received it at the time of his death (secs. 2104 and 2105). In addition, individuals who are neither citizens nor domiciliaries of the United States are not subject to estate tax liability with respect to stock or debt obligations of a foreign corporation. There is no estate tax liability in the case of an obligation of a U.S. corporation's foreign finance subsidiary, or in the case of a foreign corporation established to hold U.S. assets.

Tax treaty exemptions

In addition to the statutory exemptions listed above, various income tax treaties of the United States provide either for an exemption or a reduced rate of tax for U.S. source interest paid to foreign persons. The exemption or reduced rate applies only if the income is not attributable to a trade or business conducted in the United States through a permanent establishment or fixed base located in the United States.

It is generally the negotiating position of the United States, as expressed in Article 11 of the Treasury's model income tax treaty, to exempt interest from withholding unless the income is effectively connected with a permanent establishment or fixed base. The treaty exemption is based on the assumption that the interest income will be taxed in the country of residency in any event.

Interest generally is exempt under treaties with Austria, Denmark, Finland, West Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, the Netherlands, the Netherlands Antilles, Norway, Poland, Sweden, the U.S.S.R., and the United Kingdom. Reciprocal reductions in rate are provided under treaties with Belgium, Canada, Egypt, Morocco, and the Philippines (15 percent), Jamaica and Malta (12.5 percent), Korea (12 percent), France, Japan, and Romania (10 percent), and Switzerland (5 percent). Under some treaties, only certain interest (such as bank interest or interest on public debt) is exempt.

Treaty shopping.—Although the treaty exemptions are intended to benefit only residents of the treaty country, it has been possible, as a practical matter, for investors from other countries to obtain the benefits of those treaties providing an exemption from U.S. tax on U.S. source interest income. Investors from countries which do not have tax treaties with the United States, or from countries which have not agreed in their tax treaty with the United States to

a reciprocal exemption of interest (e.g., Canada and France), can effectively secure the exemption by lending money through a country having a treaty with the United States that contains the interest exemption. The foreign investor does this by establishing a subsidiary, trust, or other investing entity in the treaty country which makes the loan to the U.S. person and claims the treaty exemption for the interest it receives.

If the investment entity is established in an appropriate country, it may be possible for the investing entity in turn to pay the interest to the foreign investor or to a tax haven entity without any tax liability to the recipient. The tax deduction in the treaty country for this payment may eliminate or minimize the investing entity's tax liability. This use of U.S. tax treaties by third country investors to avoid any tax on the interest income rather than to avoid a potential double tax is referred to as "treaty shopping." As discussed below, a more important treaty shopping use of U.S. tax treaties is the use by U.S. corporations of the U.S. treaty applicable to the Netherlands Antilles (and, in a few cases, other treaties) to obtain an exemption from U.S. tax on interest paid to foreign investors on bonds issued by the U.S. corporations through Antilles (or other country) finance subsidiaries.

In the last two years, the United States has given unilateral notice of termination of income tax treaties with nineteen countries and territories. The treaties were extensions of treaties between the United States and the United Kingdom and Belgium. Many of these treaties, before termination, offered treaty shopping opportunities for third country investors.

In 1981, the Senate returned to the President a proposed treaty with the British Virgin Islands that would have allowed, like the U.S.-BVI treaty then in force, use by third country investors. In 1982, the United States gave notice of termination for the income tax treaty with the British Virgin Islands that was then in force. This notice occurred after the Treasury Department had found potential for tax abuse in the operation of that treaty.[1]

In June 1983, the United States terminated the income tax treaties with Anguilla, Barbados, Belize, Burundi, Dominica, Falkland Islands, Gambia, Grenada, Malawi, Montserrat, Rwanda, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, Seychelles, Sierra Leone, Zaire, and Zambia. There was also potential for third country residents to use many of these treaties.

Compliance with tax liability on interest income

U.S. payors are generally required to file information returns to report the payment of interest (including original issue discount) of $10 or more. Nominees are generally required to file reports with respect to interest received and passed along to the beneficial owners. One copy of the return is required to be sent to the recipient of the interest and another copy is sent to the Internal Revenue Service.

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[1] A discussion of treaty shopping involving that treaty appears in Vogel, Berstein & Nitsche, "Inward Investments in Securities and Direct Operations Through the British Virgin Islands: How Serious a Rival to the Netherlands Antilles Island Paradise?" 34 Tax L. Rev. 321, 360 (1979).

Returns are generally required for amounts paid on corporate indebtedness. However, no information reporting is required in the case of interest paid to (or original issue discount accruing for) foreign investors if withholding tax is imposed on the payment or if withholding tax would be imposed but for an exemption from withholding either because the amounts are eligible for a treaty exemption or the exemption for deposits with banks or because they are effectively connected with a U.S. trade or business, or if certain other limitations apply.

The Code generally disallows the interest deduction (and a reduction in earnings and profits) to the issuer of corporate debt that is in bearer form. Generally, it also generally either imposes an excise tax on the issuer of bearer debt or disallows capital gains treatment or a loss deduction to the holder of bearer debt. In general, the requirement that obligations be registered does not apply if they are issued under arrangements reasonably designed to insure that they are sold only to persons who are not United States persons and the interest on the obligations is payable only outside the United States and its possessions. In addition, a statement must appear on the face of the obligation to indicate that any U.S. person who holds the obligation will be subject to limitations under U.S. income tax laws. These rules were enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").

To the extent an obligation is subject to withholding on amounts paid to a foreign investor, such interest is not subject to back-up withholding (sec. 3406(b)(1)). Back-up withholding applies at a rate of 20 percent to any reportable interest payment paid or credited at a time when the payor has no taxpayer identification number (TIN) for a payee or has been notified that the TIN supplied by the payee is incorrect, or that the payee has failed to report an amount of interest or dividend income, or the payee has failed to certify that he is not subject to backup withholding (when required to do so).

As described above, withholding is generally required when interest is paid to a foreign investor. The Code (secs. 1441(c)(2) and 1442(a)) authorizes the Treasury to require this withholding in any situation in which the beneficial owner of securities on which the interest is paid is unknown to the withholding agent. This authority has been exercised generally to require withholding in all such situations (Treas. Reg. sec. 1.1441-3(c)(4).) In addition, Form 1042S must be provided by the withholding agent to the payee when amounts have been withheld.

In order to secure a treaty exemption or reduction from U.S. withholding tax on U.S.-source interest income, a foreign resident must file (or the resident's trustee or agent receiving the interest income must file on his behalf) IRS Form 1001 (Ownership, Exemption, or Reduced Rate Certificate). Form 1001 requires the disclosure of the identity and address of the owner of the bond. In the case of a bearer bond, the form must be presented to the payor by or on behalf of the foreign owner with each coupon. TEFRA requires the Treasury to establish procedures for insuring that treaty benefits are available only to persons entitled to them. The Treasury could, for example, require recipients to certify their residence or to claim refunds for tax automatically withheld.

Even where the foreign investor presenting an interest coupon on a corporate bond is not entitled to a treaty rate reduction or exemption, the foreign investor is nevertheless required to present, with each such coupon, a certificate of ownership on Form 1001. (The information required by that form is described above.) Where the owner of the bond is unknown to the person presenting the coupons for payment, the regulations further provide that the first bank to which the coupons are presented for payment is to require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee (Treas. Reg. sec. 1.1461-1).

Background

Eurobond market

A major capital market outside the United States is the Eurobond market. It is not an organized exchange, but rather a network of underwriters and financial institutions who market bonds issued by private corporations (including but not limited to finance subsidiaries of U.S. companies—see discussion below), foreign governments and government agencies, and other borrowers.

In addition to individuals, purchasers of the bonds include institutions such as banks (frequently purchasing on behalf of investors with custodial accounts managed by the banks), investment companies, insurance companies, and pension funds. There is a liquid and well-capitalized secondary market for the bonds with rules of fair practice enforced by the Association of International Bond Dealers. Although a majority of the bond issues in the Eurobond market are denominated in dollars (whether or not the issuer is a U.S. corporation), bonds issued in the Eurobond market are also frequently denominated in other currencies (even at times when issued by U.S. multinationals).

In general, debt securities sold in the Eurobond market are free of taxes withheld at source, and the form of bond, debenture, or note sold in the Eurobond market puts the risk of such a tax on the issuer by requiring the issuer to pay interest, premiums, and principal net of any tax which might be withheld at source (subject to a right of the issuer to call the obligations in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued). U.S. multinational corporations issue bonds in the Eurobond market free of U.S. withholding tax through the use of finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles. Foreign issuers offer bond issues not subject to withholding tax in their home jurisdiction either through foreign finance subsidiaries (e.g., Germany, at least in the case of financings for use outside Germany) or through specific statutory exemptions.

In some cases, the statutory exemptions apply to interest paid to foreign investors generally (e.g., the Netherlands and Sweden) or, more frequently, the exception is contingent on the bond being issued in a foreign currency (e.g., Japan). Because the Eurobond market is comprised of bonds not subject to withholding tax by the country of source, an issuer could not easily compete for funds in

the Eurobond market if its interest payments were subject to withholding tax.

Unlike bonds issued in the U.S. capital market, Eurobonds are issued in bearer (rather than registered) form so that the interest and principal payments must be effected by presenting the coupons or bonds to a designated paying agent. Since the bonds are issued in bearer form, the anonymity of the holder of the bond is protected—the holder's identity is not disclosed to the issuer or to the government of the country of issue.

International finance subsidiaries

When U.S. corporations borrow abroad (such as on the Eurobond market), they generally do so through the use of finance subsidiaries. Finance subsidiaries are usually paper corporations without employees or fixed assets which are organized to make one or more offerings in the Eurobond market, with the proceeds to be relent to the U.S. parent or to domestic or foreign affiliates. The interest and principal on the bonds issued by the finance subsidiary are guaranteed by its parent. The use of finance subsidiaries (described below) is intended to avoid any U.S. withholding taxes on the interest paid to the foreign bondholders.

The type of corporation used will depend, in part, on the intended use of the proceeds. If a corporation seeks money for use abroad, it will sometimes form a special U.S. finance subsidiary—an "80/20 company"—through which it issues bonds. As noted earlier, even though the borrower (the finance subsidiary) is a U.S. corporation, interest paid by it to foreign lenders will be treated as foreign source income, and hence will not be subject to withholding, if less than 20 percent of the finance subsidiary's gross income is from U.S. sources. This gross income requirement usually is met if the U.S. finance subsidiary invests the borrowed funds in the foreign operations of the corporate group.

The most common practice of borrowers, particularly those seeking funds for use in the United States, is to establish a finance subsidiary in the Netherlands Antilles.[2] This structure is designed to avoid the U.S. withholding tax by claiming the benefits of the tax treaty between the United States and the Netherlands as extended to the Antilles. The subsidiary borrows funds from foreign lenders,

[2] Taxpayers have also pursued the establishment of finance subsidiaries in three U.S. possessions: Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands. The United States does not impose withholding tax on payments of interest, dividends, and other passive income to corporations organized in those possessions. Those possessions generally use the Internal Revenue Code as their territorial income tax law by substituting the name of the possession for the words "United States" as appropriate. These "mirror code" rules include the "80/20" source rule that interest and dividends paid by a corporation organized in the possession are not possession source income if less than 20 percent of the corporation's income is from sources in the possession. A possession subsidiary whose sole activity is lending money to its (non-possession) U.S. parent, according to some taxpayers, would earn only non-possession source income. Therefore, taxpayers have contended that payments of interest and dividends from such a corporation to a foreign investor are free of possession withholding tax. (No other finance subsidiary device claims this treatment for dividends.) Temporary Treasury regulations, however, indicate that income derived from one of these possessions that is not subject to tax to the recipient there is U.S. source income. Under the mirror concept, then, income derived from the United States (such as interest paid from a U.S. corporation to a Guamanian finance subsidiary) that is not subject to U.S. tax to the recipient (because of the U.S. rule exempting such income from tax) is possession source income. Therefore, the 20 percent rule does not apply, and the possession must impose a 30 percent withholding tax on payments from the finance subsidiary to the foreign investor.

and the subsidiary then relends the borrowed funds to the parent or to other affiliates within the corporate group.

The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S. parent (or other affiliates). Alternatively, the subsidiary's indebtedness is secured by notes of the U.S. parent (or other affiliates) issued to the Antilles subsidiary in exchange for the loan proceeds of the bond issue. Under this arrangement, the U.S. parent (or other U.S. affiliate) receives the cash proceeds of the bond issue but pays the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders.

Pursuant to Article VIII of the treaty, an exemption is claimed from the U.S. withholding tax on the interest payments by the U.S. parent and affiliates to the Antilles finance subsidiary. The interest payments which the Antilles subsidiary in turn pays to the foreign bondholders are not subject to tax by the Antilles. Although most or all of the income of the Antilles finance subsidiary consists of interest payments from its U.S. parent and affiliates, that interest income would not ordinarily be treated as effectively connected with a U.S. trade or business of the Antilles subsidiary.

Consequently, since less than 50 percent of the gross income of the Antilles finance subsidiary is effectively connected with a U.S. trade or business, no part of the interest paid by the Antilles finance subsidiary to the foreign bondholders would be considered to be from U.S. sources and, accordingly, no U.S. "second-tier" withholding tax would be imposed (sec. 861(a)(1)(C)).[3] Thus, no tax is paid on the interest paid by the U.S. company to its Antilles finance subsidiary, or on the interest paid by the Antilles finance subsidiary to the foreign bondholders, either to the United States or to the Netherlands Antilles. Use of a foreign subsidiary may also increase the parent's ability to utilize foreign tax credits, because the net income of the subsidiary will be foreign source income in the hands of the parent. It will be currently taxable under the anti-tax haven type activity rules of Subpart F.

Borrowings by U.S. corporations in the Eurobond market occurred originally as a result of a program adopted by the U.S. Government during the 1960s at a time of fixed exchange rates. The program, designed to prevent the devaluation of the dollar, included several measures to encourage U.S. companies to borrow overseas, including the Interest Equalization Tax, the Foreign Direct Investment Program, the related Voluntary Foreign Credit Restraint Program, a relaxation of the no-action letter policy of the Securities and Exchange Commission with respect to foreign offerings by U.S. corporations, and the ruling policy of the IRS which encouraged foreign borrowings through finance subsidiaries. In the case of finance subsidiaries, domestic or foreign, the IRS was prepared to issue private rulings that no U.S. withholding tax applied if the ratio of the subsidiary's debt to its equity did not exceed 5 to

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[3] Even if the income of the finance subsidiary (the interest it receives from its U.S. parent and affiliates) were treated as effectively connected with a U.S. trade or business, the interest paid by the Antilles finance subsidiary would nevertheless be exempt from U.S. tax under Article XII of the treaty. This situation is advantageous when the taxpayer is in an excess foreign tax credit position because, while subject to U.S. tax on its net income (the spread between the interest it receives and the amounts it pays to the foreign bondholders), the finance subsidiary is not required to make an election to be subject to Netherlands Antilles tax in order to be free of the U.S. withholding tax.

1 and certain other conditions were met. Numerous private rulings were issued on this basis. Finance subsidiaries were also sanctioned by a number of published rulings.[4] Following the decision by the United States to abandon the fixed exchange rate system and to allow the value of the dollar to be determined by market forces—with the consequent termination of these measures to support the dollar—Eurobond offerings by U.S. corporations decreased. This decrease was in large part due to questions as to whether finance subsidiaries qualify for the exemption from the U.S. withholding tax, questions which arose when the IRS, citing the expiration of the IET, revoked its prior rulings that properly structured finance subsidiaries would qualify (Rev. Rul. 74-464, 1974-2 C.B. 46).

Because of a finance subsidiary's limited activities, the lack of any significant earning power other than the parent guarantee and the notes of the parent and other affiliates, and the absence of any substantial business purpose other than the avoidance of U.S. withholding tax, offerings by finance subsidiaries involve difficult U.S. tax issues in the absence of favorable IRS rulings. Since the marketing of the bond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the U.S. parent for payment of principal and interest, there is a risk that the bonds might be treated as, in substance, debt of the parent, rather than the subsidiary, and thus withholding could be required.[5] (This risk would appear to increase where, as is sometimes the case, the bonds are convertible into stock of the parent.)

Alternatively, the creation of the finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax on the U.S. parent with the result that the exemption might not apply (Code sec. 269). Nevertheless, these finance subsidiary arrangements do in form satisfy the requirements for an exemption from the withholding tax and a number of legal arguments would support the taxation of these arrangements in accordance with their form. In any event, notwithstanding the refusal of the IRS since 1974 to issue rulings with respect to Antilles finance subsidiaries, many bond issues have been issued since 1974 (with the number of issues increasing in recent years) on the basis of opinions of counsel.[6]

In recent years, however, field agents of the IRS have challenged certain arrangements involving Antilles finance subsidiaries.[7] The outcome of these challenges is not yet clear.

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[4] Rev. Rul. 73-110, 1973-1 C.B. 454; Rev. Rul. 72-416, 1972-2 C.B. 591; Rev. Rul. 70-645, 1970-2 C.B. 273; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 69-377, 1969-2 C.B. 231.

[5] Compare, e.g., *Aiken Industries, Inc.*,, 56 T.C. 925 (1971) and *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72-2 U.S.T.C. Paragraph 9494, *cert. denied*, 406 U.S. 1076, with *Moline Properties*, 319 U.S. 436 (1943), 43-1 U.S.T.C. Paragraph 9464 and *Perry R. Bass*, 50 T.C. 595 (1968).

[6] For detailed discussions of Eurobond financings through finance subsidiaries and of the legal issues presented, see Povell, "International Finance Subsidiaries Under Attack", in Practising Law Institute, Foreign Tax Planning 1983 9 (1983); Lederman, "The Offshore Subsidiary: An Analysis of the Current Benefits and Problems", 51 Journal of Taxation 86 (August 1979); and Chancellor, "Eurobond Financings", U. So. Cal. Tax Inst. 345 (1971).

[7] According to one source, there have been challenges to at least 25 of these arrangements. See 46 Taxes International 13 (August 1983). One company, Texas International Airlines, has disclosed such an audit in a proxy statement. Failka, "Closing a Loophole," Wall Street Journal, Oct, 11, 1982, at 17, col. 2.

The United States and the Netherlands Antilles are now in the process of renegotiating the existing treaty. The representatives of the Antilles in these negotiations have sought to continue treaty shopping benefits available in the current treaty on the ground that the United States needs the "financial pipeline" that the Antilles provide.[8]

Typically, the U.S. parent and the finance subsidiary agree to indemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties) should the IRS successfully attack the claimed exemption from U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the basis for the claimed exemption. Also, the bonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

Table of interest paid and tax withheld

The following table shows portfolio interest and withholding on that income for 1981, based on information returns filed with the Internal Revenue Service. The information is arranged according to the payee's country of address, which is not necessarily his country of residence.

Portfolio Interest Paid to Foreign Recipients and U.S. Tax Withheld—1981

(Millions of dollars)

Country	Interest paid		U.S. tax withheld		Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
Bahamas	3.4	0.1	0.9	0.9	11.4
Belgium	24.2	.7	3.3	3.5	13.6
Bermuda	19.2	.6	5.0	5.2	26.0
Canada	487.3	14.5	34.6	36.3	7.1
France	180.5	5.4	8.7	9.1	4.8
West Germany	192.0	5.7	.4	.4	.2
Hong Kong	4.6	.1	.8	.8	17.4
Italy	14.2	.4	.9	.9	6.3
Japan	158.2	4.7	7.3	7.7	4.6
Luxembourg	20.4	.6	.5	.5	2.5
Mexico	6.5	.2	1.1	1.2	16.9
Netherlands	200.1	5.9	.5	.5	.2
Netherlands Antilles	1,037.0	30.8	1.4	1.5	.1
Panama	11.5	.3	1.3	1.4	11.3
Saudia Arabia	207.5	6.2	(1)	(2)	(2)
Sweden	8.5	.3	.1	.1	1.2
Switzerland	349.2	10.4	15.9	16.7	4.6

[8] See Fialka, "Closing a Loophole," Wall Street Journal, Oct. 11, 1982, at 17, col. 2.

Portfolio Interest Paid to Foreign Recipients and U.S. Tax Withheld—1981—Continued

(Millions of dollars)

Country	Interest paid		U.S. tax withheld		Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
United Arab Emirates....	1.6	(2)	(1)	(2)	(2)
United Kingdom.....	326.0	9.7	1.7	1.8	.5
Other countries.....	112.9	3.4	10.8	11.3	9.6
Total.....	3,364.7	.....	95.3	.....	2.8

[1] Less than $50,000.
[2] Less than one-tenth of 1 percent.

Source: Internal Revenue Service, Foreign Returns Analysis Section.

Prior Congressional Action

In connection with its consideration of the Tax Reform Act of 1976, the House Committee on Ways and Means voted to repeal the 30-percent withholding tax on both interest and dividends. However, the House of Representatives removed this provision from the bill by a vote of 301-119. The Senate Committee on Finance proposed an amendment which would have repealed the 30-percent tax on interest only. However, this amendment was deleted from the bill on the Senate floor by a vote of 54-34.

In 1979, the Senate Committee on Finance reported H. R. 2297, repealing the U. S. withholding tax on portfolio interest paid to foreign lenders, but the Senate did not act on that bill.

In 1980, the House Committee on Ways and Means held hearings on a similar bill, but did not take further action on it.

Explanation of the Bill

Withholding tax

Under S. 1557, interest paid by a U. S. borrower on three categories of debt instruments ("assumed debt", "bearer debt", and "registered debt") would generally be exempt from U. S. tax (under Code secs. 871(a) and 881) if received by a nonresident alien individual or a foreign corporation.

The first category of exempt interest is interest paid on certain obligations assumed by U.S. corporations after the date of enactment ("assumed debt"). For the interest to be exempt, the U.S. corporation must have assumed an obligation that was issued on or before the date of enactment. When originally issued, the later-assumed obligation must have been guaranteed by a U.S. corporation and must have been sold pursuant to arrangements reasonably designed to ensure that it would be sold (or resold in connection with the original issue) only to non-U.S. persons. The exemption of interest in this category generally allows U.S. corporations that assume debt of Netherlands Antilles financing subsidiaries to pay tax-exempt interest on that debt. Many contractual arrangements among U.S. borrowers, Netherlands Antilles financing subsidiaries and foreign lenders contemplate assumption by the U.S. borrower in the event of repeal of the 30-percent U.S. tax. The proposal would also generally allow U.S. corporations that assume debt of "80/20" companies to use the proceeds of those borrowings to generate U.S. source income.

The second category of exempt interest is interest on certain obligations not in registered form, i.e., payable to the person who has physical possession of the paper debt instrument ("bearer debt"). For the interest to be exempt, there must be arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons, the in-

terest must be payable only outside the United States and its possessions, and on the face of the obligation there must be a statement that any United States person who holds it will be subject to limitations under the United States income tax laws. This exemption would apply to the debt of any U.S. issuer, not just to debt of U.S. corporations. Therefore, it would apply to obligations of the United States and its agencies.

The third category of exempt interest is interest on an obligation in registered form if the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) has received a statement that the beneficial owner of the obligation is not a U.S. person ("registered debt"). The statement must either (1) purport to be from the beneficial owner of the obligation or (2) actually be from a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business. The statement would not have to identify the owner, but simply to state that the owner was not a U.S. person. The Secretary of the Treasury would have authority to publish a determination to the effect that statements from a securities clearing organization, bank, or other financial institution, or any class of such persons, are not adequate to qualify an obligation for this category. Interest paid more than one month after publication of a notice of inadequacy would be subject to the 30-percent tax, and the agent paying interest in such a case would have a duty to deduct and withhold U.S. tax. This exemption, like the bearer debt exemption, would apply to the debt of any U.S. issuer.

Not all interest on instruments in these three categories would be exempt from U.S. tax. Interest would not be entitled to the exemption from U.S. tax if it were effectively connected with the conduct by the foreign recipient of a trade or business within the United States and thus would be taxed at the regular graduated rates. Also, otherwise exempt interest on bearer debt or registered debt would not be exempt if paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the capital or profits interest of the partnership.

Foreign banks would generally not be entitled to the exemption for interest they received on either bearer debt or registered debt on an extension of credit pursuant to a loan agreement entered into in the ordinary course of their banking business. Foreign banks would, however, be exempt from U.S. tax on interest paid on bearer or registered obligations of the United States.

To prevent U. S. persons from indirectly taking advantage of this exemption, the bills provide that a foreign corporation which is a controlled foreign corporation (within the meaning of sec. 957) is not to be entitled to the exemption for interest on bearer debt or registered debt received from U. S. persons.

Interest on assumed debt would be free of U.S. tax even in the hands of foreign persons having direct ownership interest in the U.S. payor, in the hands of a foreign bank, or in the hands of controlled foreign corporations.

Estate tax

The bill would also eliminate any potential U. S. estate tax liability of nonresident alien individuals, in the case of obligations the income from which, if received by the decedent at the time of his death, would be exempt from tax.

Prevention of tax evasion

The bill would provide that if the Secretary of the Treasury determines that the United States is not receiving sufficient information from a foreign country to identify the true beneficial recipients of the interest payments and if the Secretary believes such information is necessary in order to prevent evasion of taxes, the exemption would no longer apply to payments addressed to or for the account of persons within that country for future issuances of debt obligations. The termination would continue until the Secretary determines that the exchange of information between the United States and that country is sufficient to identify the beneficial recipients of the interest. Any termination of the exemption for interest will also automatically terminate the exemption from the estate tax on debt obligations.

Under the bill, an explicit duty to deduct and withhold would arise only if the person otherwise subject to the duty knows, or has reason to know, that the income is taxable because the recipient is related to the payor or because the recipient is a foreign bank. There would be no duty to withhold on payments to controlled foreign corporations. The bill would not affect the authority of the Secretary of the Treasury to require a payor to withhold in cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid. The present regulations require withholding where the ultimate recipient of the interest is unknown.

Effective date

The amendments providing for the income tax exemption would apply to interest paid after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations would apply to estates of decedents dying after the date of enactment.

Issues

Capital formation

Foreign placements of U.S. corporate bonds have increased from $4.4 billion in 1980 to $14.6 billion in 1982. During this period, international bond issues rose from 10 to 28 percent of total public debt placements by U.S. corporations.[9] This increase in interna-

[9] Morgan Guarantee Trust Co., "World Financial Markets," (August 1983) p. 17.

tional bond issues has been facilitated by the use of Netherland Antilles subsidiaries which sell bonds, guaranteed by the U.S. parent corporation, to foreign investors free of the U.S. withholding tax. Some argue that repeal of the withholding tax would increase the inflow of capital to U.S. corporations allowing financing at lower rates and larger domestic investment.

However, U.S. corporate bonds sold in the Eurobond market comprise only a small portion of total U.S. assets held by foreign investors. At the end of 1981, U.S. assets abroad totaled $557.1 billion, including $10.7 billion of corporate bonds, $64.6 billion of corporate equity, $125.1 billion of U.S. government bonds, $209.5 billion of deposits in United States banks, and $89.8 billion of direct investments.[10]

Proponents of the bill argue that repeal of the 30-percent withholding tax on interest would increase the attractiveness of medium term U.S. bonds to foreign investors. (There appears to be no significant market for long-term bonds outside the United States.) This in turn would likely result in an increased inflow of capital and a change in the type of U.S. assets held by foreign investors. If the primary effect of repeal is to cause a shift from shorter to longer term securities in the portfolio of U.S. assets held abroad and little or no net capital inflow, then the long term interest rate would tend to decline. This could benefit the U.S. economy by stimulating investment in plant and equipment, and could benefit foreign investors who would prefer to hold longer term U.S. government and corporate securities.[11]

Another possible consequence of the bill is that some foreigners who are now investing in bonds denominated in foreign currencies will switch to dollar-denominated bonds of U.S. corporations or the Treasury. This too should reduce long term interest rates in the United States. However, this net capital inflow would strengthen the dollar and have an adverse impact on the U.S. trade balance (see below).

A third consequence of repeal would be to reduce foreign purchases of stripped Treasury bonds (and other exotic securities) to the extent that foreign investors' demand for these securities is influenced by the withholding tax.

Employment and trade balance

Currently, the United States follows a policy of flexible exchange rates under which the market is allowed to set the value of the dollar relative to other currencies based on supply and demand, rather than having the government attempt to peg the value of the dollar at a particular level. In a regime of flexible exchange rates, net capital inflows strengthen the dollar. A stronger dollar reduces the dollar price of imports into the United States and makes our exports more expensive to the foreign purchasers. Thus, it tends to reduce our exports and increase imports. Consequently, if repeal of the withholding tax increases net capital flows into the United States, there will be a corresponding reduction in net exports (ex-

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[10] Bureau of Economic Analysis, "Survey of Current Business," (August 1982) p. 45, Table 3.

[11] A similar shift in the relationship between long-term and short-term interest rates would be achieved by reducing the maturity of Treasury debt issues.

ports minus imports). On balance, there is likely to be no net increase in employment; instead there is likely to be a shift of employment from export oriented sectors to capital intensive sectors within the United States. A stronger dollar also could aggravate the international debt crisis by making it more difficult for debtor countries to repay their dollar denominated debts.

These possible adverse impacts of repeal of the withholding tax are likely to be transitory. As time passes, payments of interest to foreigners will tend to depress the value of the dollar to its pre-repeal level. However, given the problems posed by the present high value of the dollar, some argue that even a temporary appreciation of the dollar should be avoided.

Control of money supply

Opponents of the repeal of the 30-percent withholding tax have argued that to the extent that international capital mobility is increased by repeal, the federal reserve system will lose a degree of control over the money supply. Proponents, on the other hand, assert that in an environment of flexible exchange rates, capital mobility does not reduce control of the domestic money supply but instead influences the exchange rate. They argue that international capital mobility actually increases the efficacy of domestic monetary policy.

Efficiency of world capital markets

Forward and futures markets in international currencies do not generally trade in maturities of longer than one year. Thus medium term U.S. corporate and government bonds are attractive to foreign investors desiring to hedge against depreciation of their home currencies relative to the dollar for a period longer than one year. The 30-percent withholding tax may limit such hedging activity and as a result reduce the efficiency of the world capital market. Proponents of repeal of the withholding tax argue that the loss in efficiency is large relative to the revenue raised by the tax. They also point out that the cost of operating Netherland Antilles financing subsidiaries, including taxes paid to the Antilles government, could be avoided if the withholding tax were repealed. Since the withholding tax raises little revenue and imposes significant efficiency costs on the U.S. economy, proponents argue that it should be repealed.

Opponents assert that the use of Netherland Antilles corporations may not be eliminated by repeal of the withholding tax because of other tax planning purposes served by these subsidiaries apart from the avoidance of the withholding tax (e.g., absorption of excess foreign tax credits). However, there may be other ways to achieve those planning purposes, and it is unclean whether many Netherlands Antilles finance subsidiaries would be used in the future.

Revenue impacts

Those in favor of repeal of the withholding tax on interest argue that there are already so many exceptions to the withholding tax that there is little point in retaining the tax in the few situations to which it does apply. In 1981, for example, only $95,336,000 was

withheld on $3,364,728,000 of portfolio interest paid to foreign taxpayers, an effective rate of 2.8 percent. Proponents of repeal argue that the repeal of withholding in the few remaining cases where it is applicable will relieve taxpayers from complying with considerable administrative burdens where the tax is not applicable and would be an important simplification.

The Treasury Department has estimated that the bill would increase revenues by $35 million to $50 million annually. This estimate presupposes that enactment of the bill would cause U.S. taxpayers to claim less foreign tax credits than they would if the bill were not enacted. The estimate is based on a number of assumptions, three of which are noteworthy. First, Treasury's estimate assumes that the U.S. taxpayers and their Nethelands Antilles finance subsidiaries claiming benefits under the Netherlands Antilles treaty are entitled to those benefits. That is, the estimate assumes that the Netherlands Antilles finance subsidiary arrangement is valid for U.S. tax purposes. Second, Treasury's estimate assumes that U.S. taxpayers are paying creditable income taxes to the Netherlands Antilles. Third, the estimate assumes that U.S. parents of Netherland Antilles finance subsidiaries will dissolve those subsidiaries upon enactment of the bill. Proponents of the bill, using these three assumptions and a similar analysis, have suggested that the revenue gain from enactment could exceed Treasury's estimate.

It is not clear, however, that it is appropriate to attribute a revenue increase to this legislation, because it is not clear that the bill would cause taxpayers to claim less foreign tax credits than they otherwise would be entitled to. First, it is not clear that Eurobond issues by U.S. companies would continue in the future (absent legislation). The progress of audits of Netherlands Antilles finance subsidiary arrangements in the ordinary course of administrative practice could cause future offerings to decrease or even to stop. Similarly, if Treasury ruled that it would not in the future treat new Eurobond issues as qualifying under the treaty, it is doubtful that any new offerings would occur. In either event, the bill could cause a substantial revenue loss. Second, it is not clear to what extent the taxes that the Netherlands Antilles imposes on finance subsidiaries are income taxes that are properly creditable rather than taxes on capital. If these taxes are not creditable, the bill would not reduce proper claims of foreign tax credits. Third, the bill would not compel liquidation of Netherlands Antilles finance subsidiaries. Therefore, if U.S. parent corporations wanted to continue use of this arrangement, they could do so. Some U.S. corporations might keep these subsidiaries in place, because they take the view that these subsidiaries generate creditable low-taxed foreign source income that enables the U.S. parent to credit other foreign taxes. If the Netherlands Antilles finance subsidiary arrangement is valid for tax purposes, then enactment of the bill would not prevent continued generation of low-taxed foreign source income and claims of foreign tax credits.

In any event, to the extent that enactment of the bill would attract additional foreign capital to the United States, it would increase the interest deductions of U.S. taxpayers. There would be no U.S. tax on the interest income (in the hands of the foreign lender)

that corresponds to this interest deduction, however. This lack of a corresponding income inclusion would tend to reduce U.S. revenues.

Equity arguments

Opponents of repeal argue that it would be inequitable to exempt foreign lenders from tax on U.S. source interest income while continuing to tax interest received by U.S. lenders. In their view, foreign lenders enjoy the income and security from investing in the United States and thus should not be exempt from paying U.S. tax on the income received, particularly since the U.S. borrowers reduce their U.S. tax by deducting the interest payments.

Proponents of repeal counter that the correct comparison is not with the U.S. treatment of U.S. lenders but with the way in which other foreign countries treat lenders from outside their borders since these rules determine the environment in which U.S. borrowers must compete for funds. Proponents point out that many other countries provide mechanisms for the issuance of Eurobonds free of withholding tax. Proponents claim that the equity argument is superficial because, in their view, foreign lenders will not pay U.S. tax on U.S. source interest income even if the United States continues to impose it; they will instead merely invest elsewhere. Moreover, they note that few foreign lenders pay U.S. tax today.

Tax avoidance and evasion

Opponents argue that if no withholding tax is imposed on interest by the country of the borrower, it would greatly increase the flow of movable capital to tax havens and bank secrecy jurisdictions, with the result that no tax would be paid on the interest to any country. In addition, because of the difficulties of enforcement, at least some of these tax-free bonds would probably be held by U.S. persons evading U.S. tax. Opponents of repeal argue that withholding at source is the only effective way to prevent tax avoidance and evasion. It is argued that repeal of withholding would undercut the long-term efforts of the United States to curb international tax evasion and avoidance, and to encourage other countries to assist in that effort. Those favoring repeal argue in response that there presently are virtually unlimited opportunities for taxpayers to evade taxes if they intend to do so and that repeal of the U.S. withholding tax on U.S. corporate bonds is unlikely to cause anyone to evade or avoid taxes who would not do so in any event. Moreover, they argue that the present method of access to the Eurobond market shows U.S. approval of complex schemes that allow the sophisticated to avoid tax.

Treaty negotiations

Opponents also argue that repeal of the withholding tax would result in the surrender of a valuable "bargaining chip" available to our tax treaty negotiators. That is, if investors residing in a foreign country would be subject to a 30-percent tax unless their country entered into a tax treaty with the United States, then their government would have a greater incentive to enter into a tax treaty to eliminate the tax. The United States could insist on a reciprocal concession as the price of such a provision. In that regard, oppo-

nents of repeal note that 36.3 percent of the revenue (as shown in the table) is from Canada, which recently has refused in treaty negotiations to agree to a reciprocal reduction of withholding rates on interest below 15 percent. Moreover, an additional 24.4 percent of the revenue is from Switzerland and Japan, which also have refused to reciprocally reduce withholding rates on interest to zero. Thus, more than three-fifths of the revenue loss resulting from unilateral repeal would merely be a transfer to the Treasuries of those countries or a windfall for investors from these four countries. If the investor was in a low tax bracket (or failed to report the income in his home country), repeal would most benefit the investor. Otherwise, absent repeal, those countries' foreign tax credit mechanisms would absorb some or all of the U.S. tax.

On the other hand, those favoring repeal argue that reliance on reciprocal rate reductions or exemptions in tax treaties is arbitrarily discriminatory in the area of portfolio investment. Proponents of repeal further argue that, even if the withholding tax were repealed, other countries would still have an incentive to enter into treaties with the United States to reduce double taxation of income other than portfolio interest and to eliminate fiscal evasion. This is particularly true if, as in the case of the bill, the repeal is targeted so that it does not generally apply to interest paid to related parties or banks. In addition, many foreign countries might prefer not to encourage their investors to export capital to the United States.

Treaty shopping

Proponents of the repeal of the tax argue that present law has a much more deleterious effect on the tax treaty program than the loss of any possible advantages that the tax may have as a bargaining chip. In order to attract needed foreign investment, they argue, the United States must permit U.S. corporations to issue tax free Eurobonds through finance subsidiaries in the Netherlands Antilles. This approval of the use of treaties by third-country nationals encourages other "treaty shopping" abuses of our tax treaty network.

Proponents of repeal argue that it would allow the United States to take a much more aggressive position in rengotiating the treaty with the Netherlands Antilles. They argue that the main benefit the United States derives from the treaty is access to the Eurobond market. They contend that if the bill passes, the United States will have much less reason to concede matters of substance to the Antilles in those negotiations. Specifically, the United States will have little or no reason to agree to the treaty shopping arrangements the Antilles seek for Antilles corporations beneficially owned by third country residents.

Moreover, they argue, the use of finance subsidiaries to accomplish essentially the same result as repeal of the withholding tax is unnecessarily complex and expensive to the corporations issuing the bonds. Their use is expensive to the U.S. Treasury since the taxes paid to the Antilles by the finance subsidiaries are claimed by their U.S. parents as foreign tax credits.

Opponents respond that the treaty shopping abuses of the Netherland Antilles and other treaties can be eliminated by simply revising the treaties—that if the problem is the avoidance of U.S. tax

through abuses of U.S. tax treaties, repeal of the tax would not be a sensible solution to that tax avoidance.

Foreign tax credit

Opponents of repeal also point out that if the foreign investor is from a high tax country, he generally will be allowed a foreign tax credit for the withholding taxes paid to the United States and therefore the repeal of withholding will not provide any greater return to him which would give him a greater incentive to invest in the United States. Instead there would only be a transfer from the U.S. Treasury to his home country's treasury.

On the other hand, proponents of repeal point out that if the investor is from a low-tax country, repeal of withholding generally would make a difference to him. Also, there are significant accumulations of wealth held by pension trusts in developed countries which may be entirely exempt from foreign tax. In this case, repeal of U.S. withholding would also provide a positive incentive to invest in the United States. Opponents argue, however, that there is no reason not to target the elimination of U.S. tax to limited classes of foreign persons through a narrow Code amendment or through a reciprocal treaty exemption. Also, depending on the mechanism his foreign country has adopted for estimated tax payments, a foreign investor may lose the use of the amount withheld for the period between the time the U.S. tax is withheld on the interest and the time he can secure a credit from his government. Opponents of repeal also argue that if the 30 percent rate is too high, then some reduction of that rate rather than elimination of the tax is appropriate. They argue foreign investors will generally care about the strength of the dollar and the U.S. economy. They argue that even if combined with elimination of treaty shopping opportunities, repeal would have little effect on foreign demand for U.S. debt.

Foreign banks

Under present law and Treasury regulations, foreign banks are subject to the regular U.S. corporate income tax on income that is effectively connected with a U.S. trade or business. If is it not effectively connected, they are subject to the 30-percent U.S. gross withholding tax (unless a treaty rate reduction of exemption applies). Repeal of the withholding tax on assumed debt would make it possible for foreign banks to receive interest payments on assumed debt without payment of either the regular corporate tax or the withholding tax. This tax exemption, together with their exemption from reporting requirements and reserve requirements applicable to U.S. banks and extended to U.S. branches of foreign banks, could provide to these foreign banks operating from offshore a competitive advantage over U.S. banks and U.S. branches of foreign banks.

Withholding tax as a protective tariff

Proponents of repeal of the 30-percent withholding tax argue that the attractiveness of U.S. bonds in the international bond market is greatly diminished by the withholding tax, so that the tax is a barrier to international trade in assets. The marketability

of U.S. bonds abroad is limited to the extent that foreign bondholders, in non-treaty countries, are unable to claim credit for the U.S. withholding tax. This is the case for foreign tax exempt entities such as foreign pension funds and bondholders in an excess credit position. Also many foreign investors are reluctant to claim the credit because anonymity of ownership is sacrificed.

Opponents of repeal assert that the United States grants foreign jurisdictions the same right to tax interest income at its source and allows a credit for withholding taxes paid by domestic lenders. Furthermore, the United States Treasury position has been to bilaterally reduce or eliminate the withholding tax in treaty negotiations. Opponents view the tax as comparable to, and in lieu of, the income tax imposed on U.S. lenders. The tax is not designed to discourage foreign persons from buying U.S. government and corporate bonds but merely to subject them to a tax comparable to the tax paid by U.S. bondholders. They believe it would be inappropriate to eliminate the tax merely because it reduces the marketability of domestic bonds to foreign investors seeking to avoid taxation in their home countries.

Optimal rate of the withholding tax

Some opponents of repeal make the point that a lower-rate withholding tax might raise substantially more revenue than the current 30-percent tax. They argue that above a certain tax rate (less than 30 percent) collections from the withholding tax fall off because of the greater incentive for tax avoidance. This "Laffer curve" analysis suggests that the withholding tax rate should be lowered to the point at which revenue collections of the Treasury are maximized (i.e., the tax rate should be set equal to the marginal cost of tax avoidance). Such a revenue-maximizing tax might be in the range of 5 or 10 percent and probably would have to be accompanied by the closing of the Netherland Antilles "window."

Foreign policy aspects

As previously noted, one of the principal methods for the avoidance of U.S. withholding taxes on corporate obligations is the use of Netherlands Antilles finance subsidiaries. This results in considerable financial activity in the Antilles. The Antilles government has argued against repeal of the general withholding requirement in the Code on the ground that it would no longer be necessary to route borrowings through the Antilles, and the use of the Antilles as a financial center would be substantially reduced. Offshore financing activities generate a large portion of the Antilles budget. To insure the stability of the Antilles, the United States might find it advisable to replace a considerable part of these taxes with foreign aid.

Proponents of repeal point out, however, that the need to route transactions through the Antilles adds needlessly to the cost of borrowing. The same business that now generates jobs in the Antilles could be used to generate more financial jobs in the United States. Because of the availability of the foreign tax credit, some of the revenues collected by the Antilles may in effect already come out of the U.S. Treasury through reduction of the U.S. tax burden on the U.S. parent of an Antilles finance subsidiary. Further, propo-

nents of repeal argue that it is illogical from a foreign policy standpoint for the U.S. contribution to a Caribbean country's economy to be determined by that year's volume of Eurobond offerings.

Disclosure requirements

In its consideration of similar legislation in the 96th Congress, the Senate Finance Committee report made it clear that it intended that information reporting requirements remain in effect with respect to interest exempt from withholding tax. In addition, the Committee report indicated the intention that the Treasury use its authority to require withholding where the payor of the income does not know the owner of the securities on which the interest is paid. The Committee report made it clear that this authority was to be used to ensure the collection of tax where interest is paid to direct investors or CFC's.

Those who oppose an interest reporting requirement contend that it does not comport with the realities of the Eurobond marketplace and therefore would nullify any beneficial effect of the repeal of withholding. They point out that the Eurobonds issued by competing borrowers from other countries do not require withholding, are free of reporting requirements, and are typically in bearer, rather than registered, form. A requirement that the lender report his identity to qualify for exemption from withholding would impose an administrative burden on lenders and could also raise some doubt in the minds of the lenders as to whether the obligations in their hands qualified for exemption from withholding. Those arguing that there should be no disclosure requirements for obligations that generally yield tax-free income argue that the loss of anonymity would make it impossible, as a practical matter, to market the obligations of U.S. borrowers to those foreign investors who are unwilling to have their identities disclosed to the IRS. They argue that the U.S. Treasury would have less difficulty in preventing evasion of U.S. tax by U.S. taxpayers if U.S. borrowers could issue debt directly, rather than through the Netherlands Antilles. They contend that strict Antilles bank secrecy laws now make it difficult to determine the ultimate beneficial owner of debt issued by financing subsidiaries.

Those who support the information reporting requirements argue that, without these rules, it would be simple for direct investors and foreign subsidiaries to avoid the limitations on the exemption from withholding. It would be possible, although difficult, to track down interest income paid to foreign subsidiaries through the Internal Revenue Service audit process. Many U.S. shareholders of CFCs would never be audited. It would generally not be possible to audit foreign direct investors. Additionally, those supporting reporting requirements argue that their absence would assist U.S persons to evade U.S. tax by investing anonymously in bearer obligations abroad. They argue further that the principal reason foreign holders of bearer bonds would refuse to disclose their identities to the IRS is that they are evading taxes and currency control requirements of their own countries. They argue further that a decision by the United States not to require the reporting of the identity of the beneficial owner in order to increase the marketability of bonds issued by U.S. companies would be contrary to the U.S.

policy not to condone foreign fiscal fraud and contrary to the spirit of our tax treaty exchange of information obligations.

Foreign subsidiaries (controlled foreign corporations)

The bill does not generally provide an exemption for interest paid to controlled foreign corporations (CFCs)[12] on the grounds that there are a number of ways in which such an exemption could result in undue tax advantages. However, the bill does exempt CFCs from U.S. tax on assumed debt—debt assumed by U.S. corporations after the bill's effective date.

If CFCs could receive interest income free of withholding tax, U.S. tax on that income could be deferred indefinitely, if the CFC also had an active business. Alternatively, if the U.S. parent had excess foreign tax credits from unrelated foreign business operations, the interest could in effect be repatriated to the parent tax-free. Finally, even if neither of these fact patterns applies and the interest income of the foreign subsidiary is currently taxable to the U.S. parent under subpart F without being fully offset by foreign tax credits, the U.S. parent could benefit by being able to invest pre-tax dollars in U.S. debt obligations rather than only the amount remaining after imposition of U.S. tax. Each of these possibilities is explained in greater detail below.

In the case of a controlled foreign corporation (CFC), subpart F (Code secs. 951-64) provides that, in general, the United States shareholders must currently include in their income certain types of tax haven income of the corporation and certain types of passive investment income, including interest income. However, no inclusion is required if these types of income amount to less than 10 percent of the gross income of the corporation. Most corporations with active businesses abroad are eligible for this exception because the *gross* income from their business activity is generally more than 90 percent of total gross income even though their net investment income may be a larger proportion of their overall net income because of greater expenses associated with the active conduct of a business.

Advantages could exist for the U.S. shareholder of a CFC even if the shareholder were required to report the interest income currently. For example, suppose that a U.S. parent company has excess foreign tax credits.[13] If the U.S. parent lent money directly to a U.S. borrower, the U.S. parent would, of course, be taxable on the interest income. However, if the U.S. parent makes an investment (such as buying assumed debt) through a foreign subsidiary (a

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[12] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

[13] The United States taxes domestic taxpayers on their worldwide income, but allows a credit against its tax for foreign income taxes. The credit allowable in any year is limited, however, by a formula which is generally intended to allow the foreign tax credit to offset only the U.S. tax on the taxpayer's foreign source income, not the tax on its U.S. source income. Generally, the limitation is equal to the taxpayer's pre-credit U.S. tax multiplied by a fraction, the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is the taxpayer's worldwide taxable income. A taxpayer whose foreign income taxes are greater than this limit is said to have excess tax credits. The excess credits may be carried back 2 years and forward 5 years to be utilized in years in which the taxpayer's foreign tax credit limitation formula exceeds foreign income taxes actually paid. However, if the excess credits cannot be used in any of these years, they are lost forever. Many taxpayers find that, because of high foreign tax rates, they are chronically in an excess credit position.

CFC), the U.S. parent may, in effect, receive the income tax-free. The U.S. source interest income could (absent U.S. withholding) be received by the subsidiary free of U.S. tax. The only tax paid by the subsidiary would be the tax imposed by the country in which it is received, which may be considerably lower than the U.S. tax rate paid by the parent.[14] When this interest income of the subsidiary is taxed to the U.S. shareholder under subpart F as an actual or constructive dividend, the dividend may be treated as foreign source income, because the CFC is a foreign corporation, even though the interest income received by the CFC was from U.S. sources. Thus, U.S. source income (the interest) may in effect be converted into foreign source income (the dividend). This increases the U.S. shareholder's foreign tax credit limitation and may permit the taxpayer to use its excess foreign tax credits from its unrelated foreign active business operations (which might otherwise expire unused) to offset completely its U.S. tax on the income, allowing the U.S. interest income to be received without imposition of any U.S. tax.

A U.S. shareholder of the CFC may obtain tax advantages from repeal of the withholding tax even if the shareholder is not in an excess foreign tax credit position. If the CFC has accumulated earnings abroad which are not subpart F income, it could not repatriate them without causing its U.S. shareholder to pay U.S. tax on the dividend income.[15] The U.S. shareholder could then reinvest only the after-tax amount of the dividend in obligations of U.S. companies. However,if the income is not repatriated, the CFC could invest the pre-tax amount of earnings (which, if foreign income taxes are low, could be considerably larger than the amount which would remain after U.S. tax) in obligations of U.S. companies. Thus, although the U.S. parent would be subject to to current U.S. tax on the interest income earned by the foreign subsidiary under subpart F (unless the 10-percent de minimis rule described earlier applied), the subsidiary would have had a larger amount available to invest, and thus would receive more income, than the U.S. parent would have had if the funds had been repatriated to it as a dividend. This could be attractive if the subsidiary were not also burdened with a withholding tax on interest received. While this would be attractive even where the higher amounts of interest income of the CFC are currently taxable to the U.S. parent under subpart F, it is particularly attractive where, on account of the 10-percent de minimis rule, the interest is not subpart F income taxable to the U.S. parent.

Those who favor extending the repeal of the withholding tax to all interest paid to CFCs point out in this last situation that discouraging the CFC from investing in debt of U.S. obligors is contrary to the policy expressed by Congress in the Tax Reform Act of 1976. Prior to the amendments made by that Act, U.S. shareholders

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[14] If the tax paid on the interest to the foreign country in which it is received is at least equal to the U.S. rate of tax, then the parent would have no incentive based on this analysis to structure the loan through the foreign subsidiary. However, if it did so, the parent would still pay no U.S. tax, so that net result would be a transfer of funds from the U.S. Treasury to the foreign country's treasury.

[15] This assumes that the U.S. shareholder would not be entitled to an indirect foreign tax credit (for taxes paid by the CFC on its income) which would eliminate U.S. tax on the dividend.

of CFCs were treated as receiving a dividend from the CFC whenever the CFC invested in the "U.S. property," including debt obligations of U.S. persons. This rule was adopted because it was felt that reinvestment of the funds in the U.S. was a repatriation essentially equivalent to a dividend. However, the 1976 Act changed this rule to permit portfolio investment in the United States without imposition of current tax under subpart F. Thus, CFCs were no longer encouraged by subpart F to reinvest earnings abroad, rather than in the United States. It was believed that this would improve the U.S. balance of payments in encouraging capital inflow from CFCs into the United States. Proponents also point out that, if a U.S. withholding tax is imposed on interest received by a CFC, and the U.S. tax on dividends from the CFC is not eliminated by the foreign tax credit, double taxation of the income will result. That is, the income will be taxed once by the United States when paid to the CFC and will be taxed a second time when paid as a dividend by the CFC to the U.S. shareholder. Proponents of the bill's approach argue that it leaves CFCs where they are under current law, because CFCs can now invest in obligations of Netherlands Antilles finance subsidiaries of U.S. corporations without incurring the U.S. withholding tax.

4. S. 1666 — Senators Chafee, Bentsen, Durenberger, Boren, Wallop, and Pryor, and others

"Capital Formation Tax Act of 1983"

Present Law

General rule

Under present law, gain or loss from the disposition of a capital asset which has been held for more than one year receives special tax treatment. Capital assets generally include property (including corporate stock) held by the taxpayer other than property held for sale to customers and property used in the taxpayer's trade or business. In addition, gain from the disposition of property used in a trade or business, in excess of depreciation recapture, may be treated as gain from the sale of a capital asset.

Noncorporate capital gains tax

Noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year, i.e., 60 percent of the excess of net long-term capital gain over net short-term capital loss. (Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year.) The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a noncorporate taxpayer's entire net capital gain is 20 percent, i.e., 50 percent (the highest individual tax rate) times the 40 percent of the entire net capital gain includible in adjusted gross income.

Capital losses of noncorporate taxpayers are deductible against all capital gains and against up to $3,000 of ordinary income in each year. In determining the amount of capital losses which may be deducted from ordinary income, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be taken into account. Capital losses in excess of these limitations may be carried over to future years indefinitely, but may not be carried back to prior years.

Corporate capital gains

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax. The highest regular corporate tax rate is 46 percent for taxable income over $100,000.

Small business corporation stock

Present law generally does not distinguish between stock of different corporations for purposes of determining the treatment of capital gains or losses on disposition of the stock.

However, under Code section 1244, losses on the disposition of certain small business corporation stock by an individual taxpayer may be treated as ordinary, rather than capital, losses. (These losses may then be deducted in full against the taxpayer's ordinary income.) This provision applies to up to $1 million of common stock issued by a qualified small business corporation more than 50 percent of whose gross receipts for its five most recent taxable years must be derived from the active conduct of a trade or business. A maximum of $50,000 ($100,000 in the case of a joint return) of ordinary loss from the disposition of qualified stock may be claimed in any taxable year.

Issues

The principal issue is whether capital gain from the disposition of stock acquired through certain initial stock offerings should be taxable at a specially reduced rate. If it is determined to apply such a reduced rate, a related issue concerns the period for which the taxpayer must hold the stock before the reduced rate will apply.

Explanation of the Bill

The bill would provide that for noncorporate taxpayers, 80 percent of net capital gain attributable to the disposition of qualified initial issues of stock, if such stock was held by the taxpayer for at least five years, would be deductible from gross income. Qualified initial issues would be defined to mean issues of stock which (1) are publicly or privately offered through an initial stock offering by a corporation,[1] (2) are purchased from the initial offeror, broker, or agent, and (3) represent contributions to capital or paid-in surplus of such corporation.

Thus, assuming current tax rates, the highest tax rate which would apply to such dispositions of qualified initial issues of stock would be 10 percent, i.e., 50 percent (the highest individual tax rate) times the 20 percent of allocable net capital gains includible in adjusted gross income (assuming the alternative minimum tax did not apply). Net capital gain in excess of the gain attributable to the disposition of qualified initial issue stock would continue to be taxed at a maximum 20-percent rate. The bill would not affect the tax treatment of net capital losses attributable to the disposition of qualified initial issue stock.

The provisions of the bill would not affect the tax treatment of capital gains of corporate taxpayers.

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[1] It is understood that the definition of initial stock issues under the bill is not intended to be limited to the first issuance of stock by a corporation, but includes any initial stock offering (as contrasted with a secondary stock offering.)

Effective Date

The bill would apply to sales and exchanges of qualified initial issue stock occurring after December 31, 1983.

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